

# Corporate Governance and Ethics of Islamic Finance Institutions

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## Abstract

Islamic finance has grown impressively since its modest beginnings with the establishment of Egypt's Mitt Ghamar Saving Bank in 1963. By the end of 2011, the global Islamic financial services industry was valued at \$1.357 trillion, a 150 percent increase in the past five years. Yet despite this growth, in nearly five decades of its existence, Islamic finance has gained only one percent of the global market share for finance. While some of this can be chalked up to the relative newness of the industry, some of its problems stem from ambiguous corporate governance model and less than stellar commitment to ethics. Islamic Shariah provides guidelines that can help this industry mitigate agency problems resulting from the duality of its objectives – improving financial efficiency and adhering to the rules of Shariah. In addition, a stronger commitment to the higher objectives of Shariah may allow the industry to escape the controversy that Islamic finance is different in form but essentially the same in substance to conventional finance.

Corporate Governance and Ethics of Islamic Finance Institutions

## I. Introduction

By the end of 2011, the global Islamic financial services industry was valued at \$1.357 trillion, a 150 percent increase in the past five years (Dar, et. al., 2012). Standard and Poor's estimates the Islamic financial services industry as having the potential to double its market value by 2015.<sup>1</sup> Despite its impressive growth, Islamic finance is less than one percent of the global financial market, which was estimated by Roxburgh, Lund, and Piotrowski (2011) to be approximately \$212 trillion by the end of 2010.

Askari, Iqbal and Mirakhor (2009) defines Islamic finance as financial and business transaction based on the principles of Islamic Shariah, which are the values and laws of Islam arising from two principal sources, the Quran, believed by Muslims to be the word of God, and the Hadiths, believed by Muslims to contain the teachings and practices of Prophet Muhammad. Islamic financial services and products are often

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### (Footnotes)

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1. *Global Islamic finance set to double by 2015, says Standard and Poor's. (2012, September 20). AMEinfo.com. Available at*  
*<http://www.ameinfo.com/global-islamic-finance-set-double-2015-312272>*

branded as Shariah-compliant.<sup>2</sup>El-Gamal (2006) explains that the phrase “Islamic finance” is made up of two words, a noun “finance” and an adjective “Islamic.” The noun “finance” implies that Islamic or Shariah-compliant financial institutions similar to their conventional counterparts are interested in the efficient allocation of financial credit and risk. However, the adjective “Islamic” suggests that Shariah-compliant financial markets are distinguished by being rooted in the legal and ethical values of Islam (Vogel and Hayes, 1998).

Islamic finance faces a difficult balancing act – striving to be similar to conventional finance by emphasizing efficiency and yet differentiating by infusing its practices with the legal precepts of Shariah. Unlike conventional finance, which eschews making judgments about morality, Islamic finance embraces the intermingling of morality with money. This poses unique challenges to both corporate governance and ethical foundations of Islamic finance. Section II of the paper compares and contrasts the norms of corporate governance in Shariah-compliant and conventional finance, providing recommendations to address some of the shortcomings in Islamic finance. Section III uses the principles of virtue ethics to draw parallels to the normative ethical structure in Islam and suggests a framework that can better reflect the values of Islam. Section IV concludes outlining current some challenges facing Islamic finance as they strive to gain wider acceptance.

## II. Corporate Governance in Conventional and Islamic Finance

### A. Conventional Finance

A modern corporation exists only in the “contemplation of the law.”<sup>3</sup> Corporate governance is broadly concerned with who has the right to control the allocation of resources in a firm. As shown in Figure 1, the modern view of a firm relies on the set-of-contracts theory where the firm is described as a “nexus of contracts.” Coase (1937), Alchian and Demsetz (1972), Jensen and Meckling (1976) and Fama and Jensen (1983) developed this theory of the firm using the ideas of principal-agent

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2. Shariah is defined in Oxford Islamic Studies Online as, “God’s eternal and immutable will for humanity, as expressed in the Quran and Muhammad’s example (Sunnah), considered binding for all believers; ideal Islamic law. The Quran contains only about ninety verses directly and specifically addressing questions of law. Islamic legal discourse refers to these verses as God’s law and incorporates them into legal codes. The remainder of Islamic law is the result of jurisprudence (fiqh), human efforts to codify Islamic norms in practical terms and legislate for cases not specifically dealt with in the Quran and Sunnah.” Oxford University Press, Available at: <http://www.oxfordislamicstudies.com/article/opr/t125/e2168>.

3. Chief Justice John Marshall from the *Trustees of Dartmouth College v. Woodward*, 4, Wheaton 636 (1819).

relations. Under the nexus of contracts viewpoint each corporate constituency such as employees, customers, suppliers, investors etc. have a contractual obligation with the firm, where the contracts specify the gains made by the contractor in exchange for any asset received by the firm.

Being a nexus of contracts, the role of the firm is then to bring together a diverse group of individuals whose otherwise conflicting goals and interests may discourage cooperation giving rise to agency problems. Jensen and Meckling (1976) defined agency relationship as, "A contract relationship which one or more persons (the principal) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal."<sup>4</sup> The principal will incur agency costs by imposing monitoring activities to make the goals of the agent align with the principal.

Contractual theory provides a justification as to why shareholders of a firm are considered by practice and law the owners of the firm. Finance text books generally proclaim that the goal of financial management is to maximize shareholder wealth.<sup>5</sup> Shareholder wealth maximization is a utilitarian argument favoring efficiency in resource allocation whereby capital is allocated to its most productive use in order to generate the highest net present value. The utilitarian philosophy argues that in the long run other stakeholders such as employees, customers etc., are fully compensated for the risks they take and the services they perform. Shareholders as the residual beneficiaries in a corporation can only participate in the "left-over" wealth after other claimants receive their due via their explicit contracts with the corporation.

Contractual theory does not give shareholders absolute right of control. To the contrary, Boatright (2002) contends, shareholders have some specific legal rights that confer, "de jure power on such matters as the election of directors, proxy proposals, charter revisions, and merger and acquisitions." The manager (agent) acts on behalf of the shareholders (principal) and are shielded from lawsuits by shareholders in

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4 The use of "utility maximizers" instead of "profit maximizers" is to highlight the fact that individuals not only try to increase monetary profits (pecuniary activities) but also attempt to increase their non-monetary (non-pecuniary) activities in order to increase their utility or satisfaction.

5 Ross, Westerfield and Jaffe (2011), "The goal of financial management is to maximize the current value per share of the existing stock." Brealey, Myers and Allen (2011), "The goal of maximizing shareholder value is widely accepted in both theory and practice."

accordance with the business judgment rule.<sup>6</sup> Other stakeholders usually do not have much say in decision making. However, occasionally they may. For example, bond covenants give bond holders certain intervention rights. The right to control and the right to residual earnings are benefits to the shareholders but these benefits come at a cost of controlling managers, collectivizing decision making, and risk bearing (Hansmann, 1996).

## B. Shariah-Compliant or Islamic Finance

Islamic jurisprudence is sparse regarding a modern day corporation, which by law is given a distinct legal form, as described in the previous section. Shariah and its interpretative corollary Fiqh provides rules for the governance of classical institutions such as trust-foundations (waqf), limited partnership (shirkah al-inan), and trustee financing (mudarabah), but their perspectives on the governance of a modern day corporation is left to analogical deduction (qiyas).

While the shareholder argument has primacy in Anglo-American economies, in Germany, France and Japan, managers view the firm as belonging to all stakeholders.<sup>7</sup> Islamic Shariah does not take side in the shareholder versus stakeholder argument. The general egalitarian nature of any religion, Islam in particular, suggests that the stakeholder rather than the shareholder model is more appropriate. Iqbal and Mirakhor (2004) argue that the governance model in Islamic economic system is designed to protect rights of all parties (stakeholders) who are exposed to any risk resulting from the activities of the firm. Stakeholder model is more holistic and largely normative but it lacks the simplicity of the utilitarian argument in the shareholder model. However, if the nexus-of-contracts view of the firm include moral justifications (not just utilitarian arguments) and expands utilitarianism to be inclusive of non-pecuniary benefits (such as happiness) then such holism can make shareholder supremacy a compelling argument. However, such is generally not the case. Islamic finance needs to give due consideration to implicit contracts because the moral arguments in Islam stem from

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6. *Business Judgment Rule is used by courts to assess if the firm's directors and management has violated their fiduciary duties. It states, "Courts will evaluate the case based on the business judgment rule. Under this standard, a court will not second guess the decisions of a director as long as they are made (1) in good faith, (2) with the care that a reasonably prudent person would use, and (3) with the reasonable belief that they are acting in the best interests of the corporation."* Cornell University Law School, available at [http://www.law.cornell.edu/wex/business\\_judgment\\_rule](http://www.law.cornell.edu/wex/business_judgment_rule) accessed 3 March 2013.
  7. Yoshimori (1995) shows that 97 percent of managers in Japan, 83 percent in Germany and 78 percent in France believe that the firm belongs to all stakeholders. While in the 71 percent of managers surveyed in UK and 76 percent in the US believe the firm to belong to shareholders.

fidelity to an unseen God.<sup>8</sup> General well-being of all stakeholders' flow from the mission of Prophet Muhammad described in the Quran as, "And We have not sent you, [O Muhammad], except as a mercy to the worlds (21:107).

The Islamic philosopher Ibn Rushd(d. 1198 CE) accepted the Aristotelian view that happiness not only includes the acquisition of measureable things (wealth, assets etc.) but also, the full range of human life and action, involving moral virtue and practical wisdom(Leaman, 2002). Drawing upon the teachings of the Quran, Ibn Rushd viewed happiness to be related to both religious virtue and intellectual acumen. In 2012 the United Nations Conference on Sustainable Development called for a more comprehensive measure of human wellbeing than traditional measures such as Gross Domestic Product (GDP). The new index will be expected to measure economic output taking into account environmental and social impacts of business activity. The Gross National Happiness Index developed by the small country of Bhutan is receiving serious consideration (Koch, 2012). While happiness cannot be measured by wealth alone, happiness is not unrelated to wealth. Satisfaction with life goes up with rise in both personal and national income (English, 2010).<sup>9</sup>

Islam does not condemn the generation of individual wealth but it does shun hoarding (Quran 9:34-35) and promotes circulation of wealth, particularly to the poor and needy (Quran 59:7). Disposition of wealth is also subjected to the rules of the Shariah regarding use and distribution of wealth. Levies come due when wealth exceeds a specific minimum amount called nisab. After a person meets all their fiduciary obligations, their excess wealth, is to be used in a way that forbids extravagance or abuse(Quran 2:190; 2:195; 9:34). Thus, one of the primary objectives of the Shariah is to ensure the preservation and growth of wealth, both public and private, but do so with paternalistic admonitions, with God being the ultimate "paternal" guide.

In this respect, the Islamic viewpoint is closely aligned with the concept of "libertarian paternalism" advanced by Sunstein and Thaler (2003). This idea is based on a notion

8. *The Quran is unequivocal in describing this fidelity, "I have created jinn and humankind only for My worship" (51: 56). Several other verses in the Quran make a similar point about the fundamental purpose of human life (See 7:59, 7:65, 7:73, 7:85 11:50, 11:61, 11:84; 23:23 and 23:32). Also note, that according to the Quran, God created two parallel species, human beings and the jinn, the former from clay and the latter from fire. Beliefs regarding the unseen jinn are deeply integrated into Muslim culture and religion (El-Zein, 2009). Popular folklore such as Aladdin and the Wonderful Lamp feature the jinn, from which is derived the English word genie.*

9. *The World Gallup Poll was conducted using a representative sample of more than 136,000 people across 132 nations from 2005 to 2006.*

that people are not entirely rational in their choices particularly when faced with complicated decision making, such as handling of money. A libertarian paternalist will, “steer people's choices in welfare-promoting directions without eliminating freedom of choice,” an idea that echoes the underpinnings of Shariah, which suggests that the “guiding hand” of God and the teachings of Prophet Muhammad enable better choices. And yet the Quran clearly states that there is no compulsion in any matters related to faith (Quran 2:256), echoing libertarian principles. While the corporate governance model of conventional finance is guided more by the principles of liberty the governance model in Shariah is tilted towards paternalistic social welfare.

Managers (agents) for Shariah-compliant institutions in addition to maximizing wealth will have the added fiduciary duty of achieving compliance with the rules and objectives of Shariah (Archer, Ahmed and Al-Deehani, 1998). Agency problems in conventional finance arise when conflict of interests impede maximization of shareholder wealth. In Islamic finance, in addition, compliance with the rules of Shariah requires additional agency costs in the form of both internal and external monitoring. The duality of objective (economic efficiency and Shariah-compliance) leads to an important innovation in governance via the introduction of the Shariah Supervisory Board (SSB), created to assure stakeholders that Islamic finance institutions comply with the rules of Shariah.

Table 1 outlines the role the SSB in the governance of Islamic financial institutions. The role of the SSB is to ensure compliance with the Islamicity of the products and to issue fatwas (juristic opinions) that explain the juristic reasoning behind such Islamicity. In addition, the SSB is responsible for verifying compliance with issued fatwas, calculating the required Islamic charity or zakat for account holders and overseeing the proper disposal of non-Shariah compliant earnings (Saidi, 2011).<sup>10</sup> The SSB issues reports to certify that financial transactions comply with their understanding of Shariah and such reports are often made an integral part of the annual

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10. Oxford Islamic Studies defines zakat or zakah as, “Required almsgiving that is one of the five pillars of Islam. Muslims with financial means are required to give 2.5 percent of their net worth annually as zakah. To practicing Muslims, zakah connotes the path to purity, comprehension of material responsibility, and an enhanced sense of spirituality. Zakah is used for the needy, for propagation of the faith, to free slaves, to relieve debtors, to help travelers, and for the administration of zakah, as well as other efforts approved by religious authorities. The primary forms of wealth subject to zakah include gold, silver, livestock, agricultural produce, articles of trade, currency, shares and bonds, and other liquid assets.” [http://www.oxfordislamicstudies.com/article/opr/t125/e2556?\\_hi=0&\\_pos=16](http://www.oxfordislamicstudies.com/article/opr/t125/e2556?_hi=0&_pos=16). Accessed 12 May 2013

report. Figure 2 shows a typical organization chart for an Islamic finance institution. The role of the SSB is clearly central to governance. Figure 3 replicates the organization chart for one of the oldest Islamic financial institutions in Malaysia, showing the ubiquity of Shariah supervision.

Islamic Finance Supervisory Board (IFSB), an international standard setting agencies for Islamic finance, recommends that Shariah-complaint institutions disclose information not only about their Board of Directors (BOD), which is mandated by national laws in almost all countries, but also about the SSB including all fatwas related to the Islamicity of relevant financial transactions.<sup>11</sup> IFSB's Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services is unclear in instances when the BOD, who are recognized by law as the fiduciary in the corporation, disagrees with the SSB, whose fiduciary status in the eyes of law is ambiguous but whose status in the eyes of stakeholders is critical.<sup>12</sup> For example, item 22 under Principle 1.2 citing the Quran (5:2) asks, "all organs of governance to work with, and not against, one another," however no guidance is provided on the mechanism to resolve inevitable conflicts.

Grais and Pellegrini (2006) document the laws governing SSBs in various Muslim majority countries. In Bahrain the SSB is appointed by the shareholders and can be dismissed by the shareholders upon recommendation of the BOD. Jordan and UAE, consistent with the recommendations by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), also apply a variation of this rule. In Indonesia, the SSB is appointed via a National Shariah Board, an autonomous body made up of Islamic scholars. In Pakistan, they must be approved by the State Bank of Pakistan. However, in most countries the appointment and removal of SSB members remain unspecified under national laws. This is particularly glaring in countries where Muslims are a distinct minority. Such non-standardization may spur innovation but it also injects confusion about the role of SSB particularly when non-shareholders (such as national bodies in Indonesia and Pakistan) gain extraordinary access in determining the product portfolio of an institution. The

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11 *Islamic Financial Services Board, (2005), Guiding Principles of Risk Management for Institutions (Other Than Insurance Institutions) Offering Only Islamic Financial Services. Available at <http://www.ifsb.org/standard/ifsb1.pdf>*

12 *Chapra and Ahmed (2002) using survey data they report that almost 86 percent of depositors in Bahraini Islamic banks and almost 95 percent in Sudanese Islamic banks were willing to withdraw their funds if they perceived the banks failing to operate in accordance with Shariah.*

possibility that a product deemed Shariah-compliant in one market may face sanctions in another is already a reality.<sup>13</sup>

One of the biggest governance challenges for Islamic finance stems from the agency costs in the SSB. The primary goal of SSB is to uphold the rules of contracting as specified by Shariah. The conflict resolution process is unclear when the SSB and the BOD end up on opposite sides of an argument. What if the SSB rules against the Islamicity of product that the BOD deems wealth maximizing? The fact that members of SSB typically get paid in basis points per funds managed (Farook and Farooq, 2011), creates yet another serious conflict of interest between the duty to maintain independence and the need to get paid for services.

Unal (2011) uncovers another complex agency problem by analyzing the relationship among the 400 SSB members who serve on a total of 1500 board positions worldwide. Most SSB members concurrently serve on multiple boards. At least one SSB member was listed on 85 boards. In 2010, only 20 Islamic scholars occupied more than 54 percent of the SSB positions (621 out of 1141). IFSB Principles do not elucidate any principles limiting the obvious agency conflicts that arise when SSB members serve on multiple boards. Garas (2012) shows that such conflicts of interests for companies operating in the Gulf Cooperation Council are routine.

One possible remedy will be to create external Shariah ratings agencies along the model of bond rating agencies. Given the scandal surrounding the ratings agencies in the recent financial crisis, healthy skepticism about their efficacy is appropriate (Mullard, 2012). However, the known problems of external ratings agencies such as failure to adequately capture risk, lack of accountability and conflict of interests can be mitigated. Duan and Van Laere (2012) posit developing ratings agencies as a public good tasked with wide and open dissemination of information. Their proposal is based on the model developed by the Risk Management Institute at the National University of Singapore, which currently produces, “daily updated default predictions on about 30,000 exchange-listed firms globally.” Applied to rating Shariah-compliance, such a system will not only be more transparent than the SSB model but also acknowledge the fact that compliance with Shariah is not dichotomous between compliance and non-compliance, but rather granular in levels of compliance. A granular system, such as assigning letter grades taking into account different aspects of compliance, will empower customers and investors with better choice architecture.

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13. Karim (2013) notes, “A recent draft law that would allow Egypt's finance ministry and state-run administrative bodies to issue Islamic bonds (*sukuk*) that are in compliance with Islamic sharia has stirred controversy. Opposition figures have criticized the move, and Al-Azhar University, Egypt's Sunni religious authority, has also contested it. Proponents, however, argue that it has the potential to save Egypt's faltering economy.”

The public good concept of external Shariah ratings agencies can draw upon the Shariah principles of accountability and trustworthiness. Bhatti and Bhatti (2010) illustrate that the Islamic concept of Hisbah or “verification for the control and observance of Islamic principles” as being historically effective when the Abbasid Caliphs appointed a muhtasib to ensure that marketplace norms were consistent with Shariah.<sup>14</sup> External Shariah ratings agencies can use the concepts of hisbah as a foundation for their public good oversight role.<sup>15</sup> This will help remove doubts among many Muslims about both the Islamicity and efficacy of Islamic finance (Pak, 2012).

However, ratings agencies are not panaceas. Corporate governance in Islamic finance institutions cannot be independent of ethical stewardship. Business ethicist MacIntyre (1984) describes the motivation to achieve higher objectives as the internal good for doing the “right” thing. The next section discusses how the tenants of virtue ethics can be harmonized in Islamic finance. Particular attention has to be placed in resolving conflicts when divine commandments are subjected to a wide variety of interpretation by religious scholars.<sup>16</sup>

### III. Ethical Foundations for Conventional and Sharia-Compliant Finance

#### A. Conventional Finance

The 1919 case of *Dodge v. Ford Motor Co.* remains a seminal court decision in favor of shareholder primacy in American corporate law.<sup>17</sup> Almost seven decades after *Berle and Means* (1932), shareholder primacy theory seemed to be settled in law and

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14. Historically, under the Islamic Abbasid Caliphate (750 CE) hisba was conducted by the appointment of an inspector for the market. That person was responsible for ensuring that marketplace norms were consistent with Shariah. The office holder of the hisba was called the muhtasib, whose job was to “correct weights and measures, enforce fair trading rules, check business frauds, audit illegal contracts, keep the market free of monopoly, and prevent hoarding of necessities” (Lewis, 2005, p. 17).

15. Quran talks about all people being accountable to the God (2:284, 65:8, 84:8, 39:47, 59:2 and 65:3). The Quran also reminds the reader that God is the ultimate Accountant (Hasiban) (4:6, 4:86, 17:14, 33:39, 6:62 and 21:47).

16. Alwani and Al-Shaikh-Ali (1993) notes that the Arabic term *ikhtilaaf* denotes taking a different position or course from that of another person either in opinion, utterance, or action. Disagreements among people are to be expected even on matters related to religion. While the words of the Quran are universally believed by Muslims to be infallible and divine, their interpretation is a fallible human endeavor. Islam does not prescribe uniformity in thought but rather encourages that the manifestation of inevitable disagreements take place within established norms and ethics. “If your Lord had so willed, He would have made humankind into one people .... (Quran 11: 118).”

17. *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919).

practice. Hansmann and Kraakman (2001) called this triumph as the “end of history for corporate law.” And yet the apparent wide acceptance of shareholder primacy is not without challenges coming from the very characteristics that form the bedrock for the shareholder primacy argument:

1. Residual claimants – For shareholders to be sole claimants of all residual gain they have to bear all the residual risk, which can only happen if all other stakeholders are compensated via “complete” contracts (Weide, 1996). However, complete contracting exists in an idealized world, which in reality is not the case.<sup>18</sup>
2. Agency relationships– Principals (shareholders) incur agency costs to align the interests of the managers (agents) with their own (Jensen and Meckling, 1976; Fama and Jensen, 1983). However, legal opinions in the US and UK have stated that the directors owe their duty to the corporation and not to the shareholders, suggesting a dilution in the principal-agent relationship in the set of contracts theory.<sup>19</sup> The law views directors as agents of the corporation and not the shareholders.
3. Efficiency–The efficiency argument suggests that shareholder wealth maximization is most effective in controlling costs, especially agency costs. However, all stakeholders cannot protect themselves from the inevitable harmful effects of shareholder primacy through perfect contracting. Numerous corporate scandals attest to the fact that shareholder cohesion and primacy have harmed stakeholders (Zona, Minoja, and Coda, 2013).

Shareholder primacy to large extent is driven by the desire to be efficient. Fairness is not explicitly a consideration. And yet for shareholder primacy to be effective ethics has to play an important role. Shefrin and Statman (1993) identify seven types of fairness that ought to be made part of corporate governance in order to prevent shareholder primacy from being unfairly lopsided: 1. Freedom from coercion; 2. Freedom from misrepresentation; 3. Equal information; 4. Equal processing power; 5. Freedom from impulse; 6. Efficiency in prices; and 7. Equal bargaining power.

Viewing ethics only within the rigid rubric of financial-economic theory relegates ethics, “into the subservient and ambiguous role of supporting some fundamental materialistic objective,” (Dobson, 1993). MacIntyre (1984) notes that, “the whole point of ethics – both as a theoretical and practical discipline – is to enable man to pass from his present to this true end.” The ethical utopia is a moral code based on ideal

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*18 McNeil (2001) suggests that contracts are incomplete “if performance of the actual terms of the agreement would leave gains from trade unrealized given the information available to the parties at the time performance takes place.”*

*19 Lonrho Ltd v Shell Petroleum Co Ltd [1980] 1 Weekly Law Reports 627 at 634 (HL). United States v Byrum 408 US 125 at 138 (1972). United Teachers Associations Insurance Co v Mackeen and Bailey 99 F 3d 645 at 650-651 (5th Cir, 1996)*

principles irrespective of the consequences of upholding that principle. Adam Smith defines this as being “perfectly virtuous” i.e. “the man who acts according to the rules of perfect prudence, of strict justice, and of proper benevolence,” (Smith, 1790). To mitigate the crippling impact of narcissism, Bowie (1991) notes that altruism will require social reinforcement and nurture. The next section illustrates how Islamic Shariah in the context of virtue ethics can promote such altruism without sacrificing wealth maximization.

## **B. Shariah Compliant Finance**

Islamic Shariah appears to be consistent with the ideas of virtue ethics, which focuses on human well-being, Eudaimonia in Greek, as a goal. Virtue ethics has four attributes, which are consistent with Shariah. First the delineation and emphasis on generally accepted virtues called internal good that motivate the wellbeing of all stakeholders. This approach places morality on the center stage rather than as a peripheral constraint to the maximization of external goods. Virtue ethics secondly emphasizes the role of moral judgment. This implies that virtue ethics is not so much about blind obedience to rules as it is about exercising sound judgment. The third aspect of virtue ethics is the role of moral exemplars. Goldman (1993) suggests that moral learning is not so much about knowing rules but the acquisition of pertinent exemplars or examples. He asserts, “A morally suitable role model may be didactically more effective than a set of behavior maxims.” Finally, virtue emphasizes the existence a community of practice that nurtures these virtues.

Pursuing the higher objectives or *maqasid* of Shariah as opposed to fidelity to literal rules will allow corporate governance in Shariah-compliant institutions to become rooted in the tenants of virtue ethics.<sup>20</sup> The Quran uses the word *khuluq* to describe both moral and ethical behavior. In the view of the thirteenth century Islamic scholar al-Qurtubi this is possible as long as revelation is the source of morality. The Arabic word *akhlaq* is derived from the Quranic word *khuluq*. Prophet Muhammad is described in the Quran as standing on the most exalted of character.<sup>21</sup> He in turn asked his followers to perfect their morals as a way to attain the pinnacle of faith.<sup>22</sup> Thus Shariah

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20. *The higher objectives of Shariah (Maqasid al-Shariah) are principles that provide the rationale and wisdom behind Islamic law. Traditional classifications of Maqasid divided the higher objectives into three levels – necessities (darurat), needs (hajiyyat) and luxuries (tahsiniyat). The necessities were limited to the preservation of faith, soul, wealth, mind and offspring (Auda, 2008). A sixth category, the preservation of dignity, can also be added.*

21. *Quran in Chapter 68 Verse 4 states, “And indeed, you (O Muhammad) are of a great moral character.”*

22. *Prophet Muhammad is reported to have said, “Those who have perfect faith are those with good moral character.” Al-Tirmidhi 1162 and Abu Daud 4682*

rests on ethical ideals and the science of ethics can be described as *Ilm-ul-Akhlaq* (the knowledge of ethical foundations in Islam). Table 2 summarizes the similarities between virtue ethics and Islamic ethics in the context of Islamic finance.

The first tenant of virtue ethics requires a definition of internal good or virtue. Fakhry (1991) asserts that virtue in Islam is conveyed through a whole range of ideas and words such as *askhayr* (goodness), *birr* (righteousness), *qist* (equity), *adl* (justice), *haqq* (truth and right), and *taqwa* (God consciousness). The idea of *khayr* is exemplified in the Quran by exhorting people of all religions to compete with each other in doing good.<sup>23</sup> Virtue is also expressed via the concept of righteousness (*birr*).<sup>24</sup> Righteousness is linked not only to *Iman* (belief in God, Angels, Revelation, Prophets, Day of Judgment and Divine Predestination) but also to social actions such as caring for relatives, orphans, people in need, the traveler and those who seek help. In addition, righteousness is tied to fulfilling promises and being patient during adversity (Quran 2:177). Righteous behavior is expected to be directed towards all human beings regardless of their religion, ethnicity, color or nationality.

Virtuous behavior is linked to the ideas of justice and fairness. The Quran for example stresses “giving full measure and weight in justice” and being “just” when testifying even when concerning a loved one (Quran 6:152).<sup>25</sup> The application of justice is not only conveyed via the concept of *birr* but also via the idea of *adl*.<sup>26</sup> Truthfulness (*haqq*) is yet another virtue that the Quran extolls.<sup>27</sup> Finally, virtue in Islam is rooted in being

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23. “For each religion is a direction toward which it faces. So race to do good. Wherever you may be, God will bring you forth all together. Indeed, God has power over all things.” (Quran 2:148). Other verses in the Quran exemplifying good conduct and character are 3:114, 5:48, 21:73, 21:90, 23:61, and 35:32.

24. “Do you order righteousness of the people and forget yourselves while you recite the Scripture? Then will you not reason?” (Quran 2:44).

25. “And do not approach the orphan's property except in a way that is best until he reaches maturity. And give full measure and weight in justice. We do not charge any soul except [with that within] its capacity. And when you testify, be just, even if [it concerns] a near relative. And the covenant of God fulfill. This has He instructed you that you may remember” (Quran 6:152).

26. “Indeed, Allah orders justice and good conduct and giving to relatives and forbids immorality and bad conduct and oppression. He admonishes you that perhaps you will be reminded” (Quran 16:90).

27. “And do not mix the truth with falsehood or conceal the truth while you know” (Quran 2:242).

conscientious of God. A person who achieves the highest levels of God consciousness is honored as a *muttaqin* (God-conscious).<sup>28</sup>

The concept of “moral judgment” can be best practiced by ensuring contracts for Islamic finance adhere not merely to the literalism of sacred texts but perhaps more importantly attain the higher objectives or *maqasid* of Shariah i.e. the preservation of faith, soul, wealth, mind, offspring and dignity. Auda (2008) describes the higher objectives of Shariah as a “purpose seeking system” consistent with Maslow’s hierarchy of needs that start with the physiological and gradually move upwards to safety, love, esteem, and finally self-actualization. The current practices of the Islamic finance industry do not engender confidence that the higher objectives or *maqasid* of Shariah are being consistently upheld.

Virtue ethics emphasizes the role of an exemplar. For Muslims the best exemplar is Prophet Muhammad but this does not negate individual responsibility in being stewards. The preferred model of leadership in normative Islam is a service-leader, a role that Islamic finance industry can attain by emphasizing social responsibility in its corporate practice.<sup>29</sup> Finally, virtue ethics emphasizes the role of a community of practice in cultivating ethical behavior. The community of practice in Islam is described as an *ummah*. Being part of an *ummah* is not limited to Muslims but encompasses all of humanity as long as they have a common purpose in practicing righteousness.<sup>30</sup> Islamic finance products appeal primarily to a small sliver of Muslims thus missing out in creating a broader coalition of a community of practice rooted in the common ethical ideals that transcend any particular religious identity.

Dean (1992) outlines eight basic virtues that contextualize the principles of virtue ethics for financial practitioners: 1. Due care and concern for others in professional activities; 2. Respect, where appropriate, confidentiality; 3. Fidelity to special responsibilities; 4. Avoidance of conflicts of interest; 5. Willing compliance with the law; 6. Acting in good faith during negotiations; 7. Respect for human well-being; 8.

28. “*This is the Book about which there is no doubt, a guidance for those conscious of God*” (*Quran* 2:2). Similar mentions describing the *muttaqin* are found in the *Quran* 49 times.

29. Prophet Muhammad said, “Every one of you is a shepherd and is responsible for his flock. The leader of the people is a guardian and is responsible for his subjects: a man is the guardian of his family and is responsible for his subjects, a woman is the guardian of her husband’s home and of his children and is responsible for them, and the servant is a guardian of his master’s property and is responsible for it. Surely, everyone of you is a shepherd and responsible for his flock.” *Sahih Bukhari* 6719 and *Sahih Muslim* 1829.

30. *Quran* 6:108, 7:34, 10:47, 10:49, 16:93, 22:34, 45:28.

Respect for liberty and constitutional rights of others. These ethical principles can easily be adopted and adapted to Islamic financial institutions because taken together they reflect the four underlying principles of virtue ethics internal good (khayar), moral judgment (attaining the maqasid of Shariah), moral exemplar (uswatunhasana) and a community of practice (ummatankhayr). Despite the ethical foundations of Islam, Islamic finance as currently practices does not adequately reflect this egalitarian spirit particularly in the context of avoiding conflicts of interests and positive vision for human wellbeing.

The growth in Islamic finance has been primarily prohibition driven where the terms of the contract are different in form but not in substance. This has created Shariah-arbitrage opportunities, essentially a form of regulatory arbitrage where Muslims in their zeal to imbue their religious values in business transactions knowingly or unknowingly pay a higher price for using essentially the same products that are sold in the conventional financial markets. El-Gamal (2008) points out that in today's age of financial engineering, Shariah-based prohibitions on certain contractual forms in conventional finance are rendered ineffective as practitioners can combine two Shariah-compliant products to replicate the payoff of an impermissible conventional financial product. A greater emphasis on ethics can avert such gamesmanship.

Islamic Finance Project at Harvard University reports that while Islamic finance contracts are technically lawful (halal) under the literal interpretations of Shariah they may not be ethical. Islamic finance needs to move from "licit to wholesome (tayyib)" by moving away from labeling products as Shariah-compliant (which reflects passive legal compliance) towards making products Shariah-based, aiming to not only fulfill the legalism of Shariah but also attaining its higher objectives.

Another systemic ethical problem facing Islamic finance is in the area of Shariah-compliant mutual funds. Shariah-compliance in Islamic mutual funds is similar to socially responsible funds (Ahmed and Adams, 2013) in that they both use negative screens such as not investing in companies that their respective clients deem as ethically or religiously impessible. However, Nienhaus (2011) point out that while socially responsible funds use positive screens such as preferring companies that support community development or poverty alleviation or renewable energy (i.e. sustainability), Islamic funds use negative secondary screens such as setting thresholds on debt ratios or how much impessible activities firms can engage in before being screened out. Islamic funds are legally Shariah-complaint with respect to prohibitions but they are not ethical as they make little or no attempt to reflect the maqasid or higher objectives of Shariah. Islamic funds can adopt well regarded international standards such as the United Nations supported Principles of Responsible Investment (PRI), whose goal is to encourage sustainable investments via adherence to six principles that are centered on

environmental, social, and corporate governance (ESG).<sup>31</sup> Out of the over 1100 financial asset owners, investment managers and professional financial services who are current signatories to PRI not a single one comes from the Islamic finance industry.

#### IV. Conclusions

Islamic finance has come a long way from its modest beginnings with the 1963 opening of the MitGhamarSavings Bank in Egypt. By 2011 the global Islamic financial services industry was valued at \$1.357 trillion although this was only one percent of the global finance market. Despite such success there is gathering concern about the sustainability of this niche market.

Shariah-compliant products limit their objectives to avoiding certain types of prohibitions, mainly *riba* (interest rates) and *gharar* (excessive speculation). The industry thus far has missed the opportunity to infuse their practices with the ethical foundations derived from Islamic sacred texts. The presence of Shariah arbitrage opportunities makes Islamic finance products inequitable and unfair thus violating the higher objectives of Shariah.

Most the innovations in Islamic finance have come from the Islamic windows of conventional banks. Many of these backs are beginning to retrench. The Banker reports that HSBC Amanah, the second largest Islamic window in the world, is closing its operations in UK, the United Arab Emirates, Bahrain, Bangladesh, Singapore and Mauritius and limiting its business to Malaysia, Indonesia and Saudi Arabia the three countries that accounted for 83 percent of HSBC's Islamic finance revenues.<sup>32</sup> UBS has withdrawn its Islamic bank from Bahrain. Likewise BNP Paribas and Societe Generale have also retrenched. In addition, out of the 24 fully sharia-compliant investment banks almost half were running at a loss in 2011.

The reach of Islamic finance is now primarily limited to the Gulf Cooperation Council countries and Malaysia. According to the accounting firm Ernst and Young the top four markets account for 84 percent of the industry assets.<sup>33</sup> The report goes on to note, "Islamic banks continue to grapple with multiple challenges relating to sub-scale operation, asset quality, negative operating income from core activities and a weak risk culture." But in assessing solutions to these problems the report emphasizes improving

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31. *Principles for Responsible Investment. The Six Principles* - Retrieved from <http://www.unpri.org/about-pri/the-six-principles/>

32. Hancock, M. (2013, January 3), "Islamic finance in 2013: Beyond the growth," *The Banker*. Available at

<http://www.thebanker.com/Markets/Islamic-Finance/Islamic-finance-in-2013-beyond-the-growth>

33. *Ernst and Young's World Islamic Banking Competitiveness Report 2013*.

contract-based innovation, missing the big picture problems - agency problems in corporate governance and less than robust focus on ethics. Despite over four decades of existence Islamic finance has yet to overcome the skepticism even among Muslims. Ahmad (2007) conducted a survey of Islamic finance customers and bankers in Bangladesh and found nearly 7 in 10 to believe that the rate of profit or markup profit charged by Islamic banks do not differ much from interest-based transactions offered by conventional finance. Seven out of ten potential patrons were unwilling to transact in Shariah-compliant products because they do not find them any different from conventional finance.

This paper points out two areas in which Islamic finance must improve. The agency costs imposed by the Shariah Supervisory Boards are substantive and their lack of transparency has become of source of ongoing controversy about the industry. This paper proposes the creation of external Shariah ratings agencies as a public good. In addition, the industry must set clearer ethical standards. The current Islamic finance industry will be better served if they deemphasize innovations based on Shariah-arbitrage and instead become Shariah-based by demonstrably incorporating adherence to the higher objectives of Shariah.

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**Table 1: Governance Roles in Islamic Financial Institutions**

This table shows the roles and responsibilities of key governance bodies in an Islamic Financial Institution. The third column shows if these roles are different from conventional financial institutions.

Governance Organ	Role and Responsibility	Relation to Conventional Financial Institutions
Board of Directors	<ul style="list-style-type: none"> <li>Set and approve overall policy and strategy</li> <li>Monitor progress toward corporate objectives</li> <li>Ensure accountability of the management</li> <li>Protect shareholder rights</li> </ul>	Applicable in similar capacity
Shariah Supervisory Board	<ul style="list-style-type: none"> <li>Set Shariah-related rules and principles</li> <li>Provide a clearance of Shariah compatibility of all products</li> <li>Oversee compliance and its verdict as to create confidence with respect to compatibility with Sharia</li> </ul>	Not Applicable
Audit Committee	<ul style="list-style-type: none"> <li>Review and supervise the financial reporting</li> <li>Provide oversight of internal and external auditors</li> <li>Ensure that the policies set by the board are followed by the management</li> <li>Ensure the accuracy of the quality and quantity of information</li> <li>Ensure that the financial statements are prepared according to the accepted reporting standards</li> <li>Ensure that the profit has been derived without the violating the teachings of Sharia</li> </ul>	Applicable, except for Sharia-compliance
Compensation Committee	<ul style="list-style-type: none"> <li>Monitor the compensation policy of senior management and key personnel</li> </ul>	Applicable in similar capacity
Nomination Committee	<ul style="list-style-type: none"> <li>Provide assessment of the Board of Directors' performance</li> <li>Replace board members</li> </ul>	Applicable in similar capacity

Source: Safieddine (2009)

Table 2: The Compatibility of Virtue Ethics and Ilm-ul-Akhlaq (Ethical Foundations in Islam)

Tenants of Virtue Ethics	Ilm-ul-Akhlaq (Ethical Foundations in Islam)
<i>Internal Good</i> : A virtue that achieves good for all stakeholders.	Akhlaq (Ethics): Virtue in Islam is conveyed through a whole range of words - khayr (goodness), birr (righteousness), qist (equity), 'adl (equilibrium and justice), haqq (truth and right), ma'ruf (known and approved), and taqwa (God consciousness or piety).
<i>Moral Judgment</i> : Exercising sound judgment and not adhering to the literalism of rules.	<i>Maqasid al Shariah</i> (Higher Objectives of Islamic Law): The pursuit of wealth maximization has to be tempered by the realization that human beings are viewed in the Quran as God's trustees on earth and as such any use or disposition of resources has to be done with a sense of fairness, equity and justice towards all stakeholders. This sense of fairness, equity and justice is best achieved by fidelity to the higher objectives of Shariah - preservation of faith, soul, wealth, mind, offspring and dignity of human beings.
<i>Moral Exemplars</i> :Emphasizing the practical demonstration of ethics not memorizing a set of behavioral maxims.	<i>Uswatun Hasan</i> (An Excellent Example): Islam's Prophet Muhammad is described in the Quran as the best exemplar. The followers of Islam are required to walk in the footsteps of the Prophet to the best of their abilities. The morals and ethics of Islam are not just words in sacred texts but are also to be reflected in the daily behavior and conduct of Muslims.
<i>Community of Practice</i> : A community to nurture ethical values.	<i>Ummatan Khayr</i> (Good Community): Muslims are described in the Quran to be the best community so long as they enjoin good and forbid evil.

Figure 1: A Firm as a Nexus of Contracts

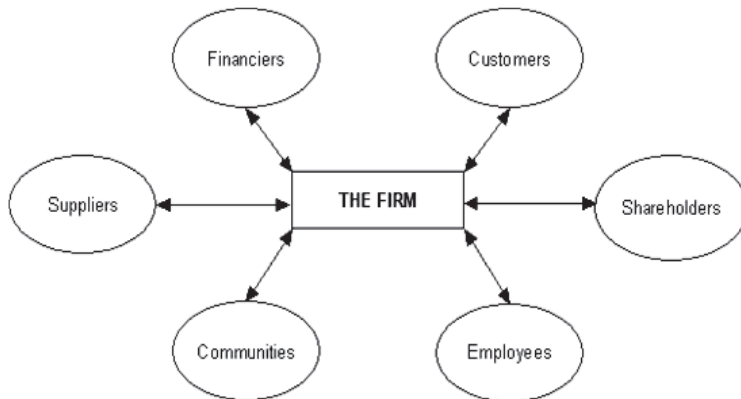


Figure 2: Sample Organization Chart Showing the Unique Role of the Shariah Supervisory Board

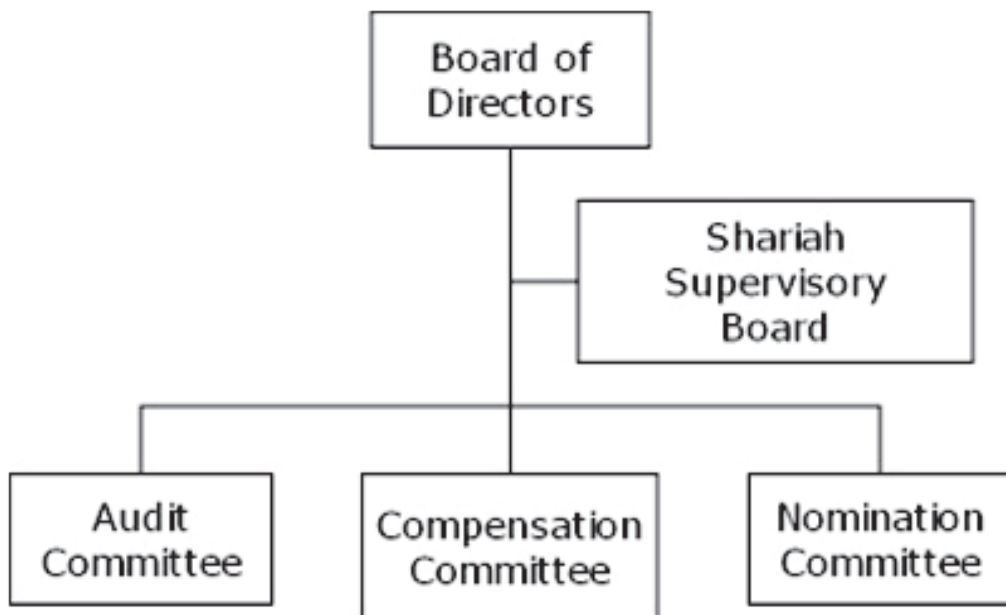
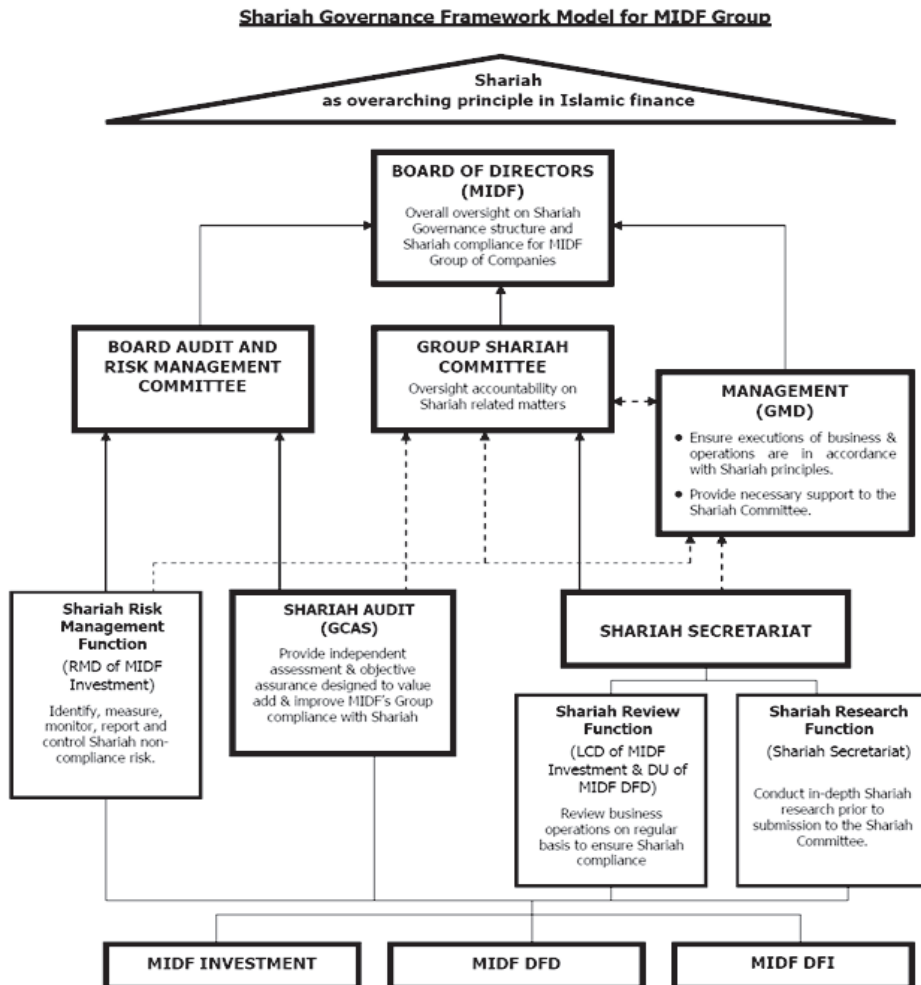


Figure 3. Shariah Governance Structure at a Malaysian Islamic Finance Firm

The Shariah governance structure at Malaysian Industrial Development Finance Berhad (MIDF) is managed by three main bodies - the Board of Directors, the Shariah Supervisory Board and the Management. Each organ is inter-dependent, in ensuring that MIDF Islamic business activities are Shariah-compliant at all times. These organs are supported by the Shariah compliance functions, comprising the Shariah review, Shariah audit and Shariah risk management function. The Shariah compliance function is assisted by the Shariah Research function handled by the Shariah-qualified officer



Note:

**MIDF:** Malaysian Industrial Development Finance Berhad.

**MIDF Investment:** MIDF Amanah Investment Bank Berhad.

**MIDF DFD:** MIDF Development Finance Division.

**MIDF DFI:** MIDF DFI Bhd.

**BARMC:** Board Audit and Risk Management Committee of MIDF.

**GCAS:** Group Control Assurance Services Division of MIDF Group.

**RMD:** Risk Management Department of MIDF Investment.

**LCD:** Legal & Compliance Department of MIDF Investment.

**DU:** Documentation Unit of MIDF DFD.

**GMD:** Group Managing Director.

**RC&F:** Revolving Credit & Factoring of MIDF DFD.

### Shariah Governance Structure.

Available at

<http://www.midf.com.my/islamic-finance/profile/if-profile/shariah-governance-control/shariah-governance-structure>.